Supreme Court, U.S.
FILED
DEC 28 1995
CLERK

No. 95-846

In the Supreme Court of the United States

OCTOBER TERM, 1995

ALVIS M. RUSHTON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a Subchapter S corporation with two shareholders is excepted from the unified audit and litigation procedures made applicable to S corporations by 26 U.S.C. 6241-6245.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A3) is unpublished, but the decision is noted at 60 F.3d 834 (Table). The opinion of the Tax Court (App., *infra*, 1a-4a) is unreported.[1]

JURISDICTION

The judgment of the court of appeals was entered on July 7, 1995. The petition for rehearing was denied on September 27, 1995 (Pet. App. A4-A5). The petition

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[1] The appendix to the petition does not include the opinion of the Tax Court, which is therefore included as an appendix to this brief.

for a writ of certiorari was filed on November 29, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Alvis M. Rushton is the president of Twenty-Three Nineteen Creekside, Inc. (App., *infra*, 2a). Creekside has two shareholders (App., *infra*, 3a n.2) and validly elected to be taxed as an "S corporation" under Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379 (Pet. App. A9).

The Commissioner of Internal Revenue conducted an audit of Creekside's return for its fiscal year ending June 30, 1985. The audit was conducted pursuant to the unified S corporation audit and litigation procedures established under Sections 6221 through 6233 and Sections 6241 through 6245 of the Internal Revenue Code. 26 U.S.C. 6221-6233, 6241-6245. Upon completion of the audit, the Commissioner made adjustments to the return and issued a notice of final S corporation administrative adjustment (App., *infra*, 2a).

2. Petitioner sought review of the adjustments in Tax Court. Petitioner asserted (i) that, under 26 U.S.C. 6244, the corporation was excepted from the unified S corporation audit and litigation procedures because it had fewer than ten shareholders (App., *infra*, 1a, 3a) and (ii) that the notice of final S corporation administrative adjustment was therefore invalid.

The Tax Court rejected petitioner's assertions and entered a final decision based upon the parties' stipulation as to the appropriate adjustments to petitioner's June 30, 1985 return (App., *infra*, 1a). Under the terms of the stipulation, petitioner reserved the

right to appeal the ruling that the unified S corporation audit and litigation procedures applied.

3. The court of appeals affirmed (Pet. App. A1-A3), relying on its decision in the companion case of *Twenty-Three Nineteen Creekside, Inc.* v. *Commissioner*, 59 F.3d 130 (9th Cir. 1995). In that decision (Pet. App. A6-17), the court noted that Congress had provided an exception to the unified audit and litigation procedures for partnerships having fewer than ten partners (Pet. App. A14). See 26 U.S.C. 6231(a)(1)(B)(i). The court concluded, however, that Congress did not create an analogous exception from those procedures for Subchapter S corporations having fewer than ten shareholders (Pet. App. A16). In reaching that conclusion, the court followed (Pet. App. A15) the decision of the Tenth Circuit in *Home of Faith* v. *Commissioner*, 39 F.3d 263 (1994), cert. denied, 115 S. Ct. 2583 (1995), and the decision of the Eleventh Circuit in *Beard* v. *United States*, 992 F.2d 1516 (1993), and rejected the contrary decision of the Fifth Circuit in *Arenjay Corp.* v. *Commissioner*, 920 F.2d 269 (1991).

ARGUMENT

The decision of the Ninth Circuit in this case and those of the Tenth Circuit in *Home of Faith* v. *Commissioner* and the Eleventh Circuit in *Beard* v. *United States* conflict with the decision of the Fifth Circuit in *Arenjay Corp.* v. *Commissioner*. The question presented in this case, however, has insubstantial prospective importance. In 1987, acting pursuant to the substantive rulemaking authority provided by 26 U.S.C. 6241, the Secretary issued

Temp. Treas. Reg. § 301.6241-1T(c)(2)(ii).[2] That regulation established an exception to the unified audit and litigation procedures of the Code for Subchapter S corporations having five or fewer shareholders. That exception applies to all tax years for which the corporation's return is due on or after January 30, 1987. Temp. Treas. Reg. § 301.6241-1T(c)(2)(i).

1. a. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, Congress established "unified" procedures that treat a partnership as an entity for purposes of audit and litigation concerning its reported income, deductions, and credits. 26 U.S.C. 6221-6233. Congress expressly excepted small partnerships from these unified audit and litigation procedures by defining the term "partnership" for this purpose to exclude partnerships having ten or fewer partners. 26 U.S.C. 6231(a)(1)(B)(i).

In the Subchapter S Revision Act of 1982 (SSRA), Pub. L. No. 97-354, § 4(a), 96 Stat. 1691, Congress further provided that the tax treatment of income, deductions, and credits of an S corporation is also generally to be determined at the corporation level in a unified proceeding, rather than in separate proceedings with respect to each shareholder. 26 U.S.C. 6241-6245.

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[2] Section 6244 (26 U.S.C.) provides that the unified audit provisions that "relate to partnership items, are (except to the extent modified or made inapplicable in regulations) hereby extended to and made applicable to subchapter S items." Section 6241 (26 U.S.C.) provides that "[e]xcept as otherwise provided in regulations prescribed by the Secretary, the tax treatment of any subchapter S item shall be determined at the corporate level."

Instead of enacting a specific set of audit and litigation procedures for S corporations, however, Congress extended and made applicable to "subchapter S items" the audit and litigation procedures applicable to "partnership items." 26 U.S.C. 6244. In particular, Section 6244 of the Code extends and makes applicable to Subchapter S items those provisions of Subchapter C (Sections 6221 through 6233 of the Code) that "relate to partnership items," including the provisions that relate to deficiencies with respect to partnership items, filing claims for credit or refund with respect to partnership items, and judicial determination of partnership items. 26 U.S.C. 6244.

b. The court of appeals correctly determined (Pet. App. A2, A15-A16) that Section 6244 of the Internal Revenue Code does not incorporate by reference the exception for small partnerships provided in Section 6231(a)(1)(B)(i). By its terms, Section 6244 extends and makes applicable to S corporation items only those provisions of Subchapter C that relate to "partnership items." 26 U.S.C. 6244. The exception for small partnerships in Section 6231(a)(1)(B)(i) is based upon the definition of a "partnership"; it does not involve the definition of "partnership items," a term that is separately defined in Section 6231(a)(3) of the Code. Compare 26 U.S.C. 6231(a)(1)(B)(i) with 26 U.S.C. 6231(a)(3). As the Eleventh Circuit explained in *Beard* v. *United States*, 992 F.2d at 1521:

> [S]ection 6244 does not incorporate section 6231(a)(1) into the SSRA. * * * [S]ection 6244 simply provides that an S corporation's income, loss, deductions, and credits are to be identified, computed, and contested pursuant to the same

> procedures that are used to identify, compute, and contest a partnership's items—namely, the unified audit and litigation procedures contained in [TEFRA]. Section 6244 does not purport to limit or define *who* must follow those procedures. It does not, by its terms, define S corporation. Rather, section 6244 merely prescribes *what* procedures must be followed when a dispute arises between the IRS and an S corporation's shareholders as to the S corporation's items, regardless of how S corporation is defined elsewhere in the Code.

Accord, *Home of Faith* v. *Commissioner*, 39 F.3d at 264.

In reaching the contrary conclusion in *Arenjay Corp.* v. *Commissioner*, 920 F.2d 269 (1991), the Fifth Circuit did not analyze these discrete statutory provisions. See *Beard* v. *United States*, 992 F.2d at 1522. Like the Tenth Circuit in *Home of Faith*, the court of appeals correctly followed the careful reasoning of the Eleventh Circuit in *Beard* and properly rejected *Arenjay*.

2. In Sections 6241 and 6244 of the Code, Congress authorized the Secretary to adopt regulations to establish exceptions to the unified audit and litigation provisions for Subchapter S corporations. See *Beard* v. *United States*, 992 F.2d at 1521; note 2, *supra*. In 1987, acting pursuant to that authority, the Secretary adopted Temp. Treas. Reg. § 301.6241-1T. See T.D. 8122, 1987-1 C.B. 342. Paragraph (c)(2) of the Regulation provides that, for taxable years for which returns are due on or after January 30, 1987, the term "S corporation shall not include a small S corporation," and then defines the term "small S corporation" to

mean an S corporation having five or fewer shareholders.

Following the adoption of this regulation, the question presented in this case would arise only with respect to Subchapter S corporations that have more than five and fewer than eleven shareholders. Even before the 1987 regulation was adopted, litigation concerning this issue was relatively sparse. For years after 1987, the question presented in this case has only a remote significance (and would arise in a legal context altered by the regulation). Further review does not appear warranted at this time.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1995

APPENDIX

T.C. MEMO 1993-179

UNITED STATES TAX COURT

DOCKET NO. 4787-90

TWENTY-THREE NINETEEN CREEKSIDE, INC., ALVIS MINICK RUSHTON, TAX MATTERS PERSON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed April 22, 1993]

MEMORANDUM OPINION

FAY, *Judge*: A number of issues have been settled by the parties, and the only issue now in dispute is whether Twenty-Three Nineteen Creekside, Inc. (hereinafter 2319 Creekside), is subject to the unified audit and litigation procedures under the provisions of subchapter D, chapter 63, subtitle F, of the Internal Revenue Code of 1954 (tax treatment of Subchapter S items). Once this Court resolves this underlying issue, the parties have stipulated the results which follow therefrom. We therefore restrict ourselves to answering the question posed by the parties.

All section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated. The parties have submitted this case fully stipulated and the facts so stipulated are found accordingly. By this reference, the stipulation of facts and attached exhibits are incorporated into this opinion. This Court allowed the parties to file their previously submitted trial memoranda as briefs of their respective positions.

For fiscal year ended June 30, 1985, 2319 Creekside's principal place of business was in Santa Rosa, California. During the year at issue 2319 Creekside had no more than two shareholders.

On August 20, 1985, Alvis M. Rushton, as president of 2319 Creekside, timely filed a Federal income tax return (Form 1120S) for the fiscal year ended June 30, 1985. Respondent examined that return under the unified audit and litigation procedures. A notice of final S corporation administrative adjustment (FSAA) was mailed to Alvis M. Rushton, tax matters person of 2319 Creekside, on December 31, 1989. The schedules attached to the FSAA indicate a disallowance of deductions for the year in the amount of $183,792.

In *Eastern States Casualty Agency, Inc. v. Commissioner*, 96 T.C. 773, 782 (1991), we held that there is no small S corporation exception to the unified audit and litigation procedures prior to January 30, 1987, the effective date of section 301.6241-1T(c), Temporary Proced. & Admin. Regs., 52 Fed. Reg.

3003 (Jan. 30, 1987).[1] This Court has continued to follow this view in subsequent cases. *Twenty-Three Nineteen Creekside, Inc. v. Commissioner*, T.C. Memo. 1991-271 (fiscal year ended June 30, 1984, of 2319 Creekside); *Cichy v. Commissioner*, T.C. Memo. 1991-270.

Petitioner contends that we should not follow the rationale set out above but should either : (1) Follow *Arenjay Corp. v. Commissioner*, 920 F.2d 269 (5th Cir. 1991), revg. and remanding an unreported Order of this Court; or (2) craft an exception for one-shareholder S corporations to the unified audit and litigation provisions.[2] However, both of these conten-

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[1] The Temporary Regulations provide that, where an S corporation consists of five or fewer shareholders, the tax treatment shall not be determined at the corporate level. The Temporary Regulations, however, are applicable only to the taxable year of an S corporation, the due date of the return of which is on or after Jan. 30, 1987. Sec. 301.6241-1T(c)(2)(i), Temporary Proced. & Admin. Regs., 52 Fed. Reg. 3003 (Jan. 30, 1987). However, the year before us is fiscal year ended June 30, 1985. By its terms, the Temporary Regulations are inapplicable to the issue at hand.

[2] During fiscal year ended June 30, 1985, petitioner contends that the corporation had no more than one shareholder for any period during the year. (Michael E. Baldigo was the 100-percent owner during the first 3 months of the fiscal year, and Alvis M. Rushton was the 100-percent owner during the last 9 months.) The burden of proof is on petitioner. Rule 142(a); *Welsh v. Helvering*, 290 U.S. 111, 115 (1933). Petitioner has presented no evidence on this issue. The Form 1120S and Schedules K-1 indicate Twenty-Three Nineteen Creekside, Inc. (hereinafter 2319 Creekside), had two shareholders during the year at issue. Additionally, the parties stipulated "Michael E. Baldigo owned a 25% interest and Alvis M. Rushton owned

tions were addressed in *Eastern States Casualty Agency, Inc. v. Commissioner*, *supra* at 782, wherein we respectfully declined to follow the Court of Appeals for the Fifth Circuit's decision in *Arenjay Corp. v. Commissioner*, *supra*, and stated we would not longer follow this Court's opinion in *Blanco Investments & Land, Ltd. v. Commissioner*, 89 T.C. 1169 (1987) (which supported petitioner's one-shareholder S corporation exception). As we have previously stated, "There are no exceptions written into the statutory language for subchapter S corporations based upon the number of shareholders." *Eastern States Casualty Agency, Inc. v. Commissioner*, *supra* at 782. "Congress has chosen to leave the question of exceptions to the discretion of the Secretary." *Id.*

Thus, for the year ended June 30, 1985, we find respondent correctly utilized the unified audit and litigation provision when issuing the FSAA to Alvis M. Rushton as Tax Matters Person for 2319 Creekside.

To reflect the foregoing,

Decision will be entered for respondent.

75% interest." Although it would not change our current opinion, we find 2319 Creekside had two shareholders.